No. 18883

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

HALLCRAFT HOMES, INC.,

Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

Appeal From the Tax Court of the United States.

APPELLANT'S REPLY BRIEF.

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~~*Petitioner and*~~ *Appellant,*

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~~*Respondent and*~~ *Appellee.*

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APPELLANT'S REPLY BRIEF.

I.

Comments on Brief for the Respondent and Delineation of the Issue on Appeal.

The Brief for the Respondent tends to prolong and dramatize the dilemma of the Tax Court. Both the Tax Court and the Respondent seem to feel, with some certainty, that the Petitioner's position is not right; but when they attempt to clearly state their own position or point out wherein Petitioner's position may be wrong, all certainty vanishes, and they fall into alternative attitudes and random quotations, taken out of context, which don't tend to present to this Court a clear-cut issue of law. In their entirety the statements,

authorities and arguments of the Tax Court and the Respondent on Appeal represent an expression of pious indignation and the exasperated conclusion that "well, gosh, everybody knows they can't do that".

Petitioner does not hold them up to scorn or blame. There is respectable authority for such loose concepts as the "assignment of income doctrine", and when they cite cases which talk about "capital standing in the place of income which had previously escaped taxation," one might superficially conclude that this *is* one of those cases and, indeed, Petitioner *cannot* convert ordinary income to capital gain merely by accepting a lump sum payment in lieu of that ordinary income which the Petitioner stood to receive over a period of years. This thinking, however, is confused and is merely the statement of a common belief, or the acceptance of a loose collection of rules of thumb, without any real insight or understanding. It is respectfully submitted that, to go along with the cursory conclusion of the Tax Court and Respondent that Petitioner's position is wrong simply because it happens to appear wrong, tends to further muddy up a very critical area of our tax law. This tendency should *not* be extended.

II.

Statement of the Precise Issue and a Plea for Clarification of a Basic and Critical Statutory Provision.

Petitioner does not wish to be repetitious or belabor a point, but it must re-emphasize the uncontested hypothesis which brings into focus the issue on Appeal.

That hypothesis, which is stipulated, agreed to, conceded and accepted, may be stated as follows:

(1) Petitioner was the owner of a valuable property right, which in essence was the contractual expectation of payments over a period of time, fixed in total amount, but *uncertain* as to the amount or frequency of installments and the ultimate collectibility thereof. [Tr. 15—Stip. 10.]

(2) The aforesaid valuable property right had been held by Petitioner at the time of the sale for in excess of six (6) months. [Tr. 29—T. C. Op.]

(3) The aforesaid valuable property right was sold by Petitioner for cash as a result of arm's length negotiations with a third party stranger, which negotiations were initiated by the buyer. It is accepted that the price was reasonable and fair, that there were good business reasons for the sale, and that any tax avoidance motives or intentions of securing a tax benefit were wholly lacking. [Tr. 29—T. C. Op.]

(4) The basic statute involved is §1221 of the Internal Revenue Code of 1954, which bears the title "Capital Asset Defined", and which says that "For purposes of this subtitle, the term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—* * *, etc., etc." The said statute lists the excluded exceptions, but *no* excluded exception could be strained to cover the valuable property right here sold. [Tr. 29—T. C. Op.]

(5) A second basic statutory provision involved is §1222 of the Internal Revenue Code of 1954 titled "Other Terms Relating to Capital Gains and Losses" and, in part, this section provides: "Long-term capital gain.—The term 'long capital gain' means gain from the

sale or exchange of a capital asset held for more than 6 months, * * *". (Resp. Br.—App. p. 3.)

(6) The Respondent, Commissioner of Internal Revenue, has promulgated his Regulations wherein he attempts to clarify and state his position with respect to the statutory law, and at §1.1221-1 under the heading "Meaning of Terms", the Commissioner has published his position as follows: "The term 'capital assets' includes all classes of property not *specifically* excluded by Section 1221. * * *" (Emphasis added.) (Resp. Br.—App. p. 3.)

The above numbered facts and statutory references are *not* in dispute, and they together form the hypothesis for the case on Appeal. Nothing could be stated with more clarity!

It is at this point, however, that the fuzzy thinking begins and the confused rationalization starts. The Respondent would impose on this high Court by asking the Court, despite the law and facts which are not in dispute, to join in a speculative search through an assortment of quotations and theories, with the wistful purpose of settling on some justification for an erroneous conclusion of the Tax Court.

Petitioner acknowledges that the authorities cited by Respondent in his Brief exist, and Petitioner is in agreement that the dictum and statements of various courts, including this Court, are sensible conclusions in the light of the specialized facts and obvious motivations which were before the courts in those cases. However, to ask this Court to indulge in a combing of authorities to find support for a sincere but superficial supposition is an affront.

To again paraphrase the Respondent, he is saying in his Brief,

> "The Tax Court's Opinion *must* be right because it seems right. The Petitioner's position *must* be wrong because it seemingly leads to a result which other courts in other cases (*and for other reasons)* have rejected."

The Respondent, with surface logic but without any depth of understanding, parrots the Tax Court's erroneous opinion and reiterates the Court's conclusion, which may be stated as follows: An unwarranted benefit and an obvious loophole would exist if sophisticated taxpayers were permitted to convert the unconditional right to receive future ordinary income into capital gain by the mere negotiation of an ostensible sale of that right, substituting a lump sum payment for future payments. This Court said just that in *Holt v. Commissioner,* 303 F. 2d 687, 691 (C. A. 9). The Respondent and the Tax Court also rely on *Merchant's National Bank v. Commissioner,* 199 F. 2d 657, 659 (C. A. 5) wherein the Court said that recoupment of amounts originally deducted from ordinary income stands in the place of the income which escaped taxation in the year of deduction.

These cases, and a host of similar cases, probably represent good law; but it is respectfully submitted that they all relate to *specialized factual situations,* and they are *corrective decisions* designed to frustrate and discourage the inventive genius of tax-motivated sophisticates who are perpetually intrigued with exploitation of the capital gain. The courts in those cases assumed a role which should not be the responsibility of our Appellate Courts. The courts, faced with a pitifully

inadequate statute on the subject of capital assets and capital gains, felt compelled to put teeth into a law, which has no teeth, by endeavoring to prevent the injustice and greed *encouraged* by Congress and the Respondent himself (Commissioner of Internal Revenue), through their own failure to provide the courts and taxpayers with a workable law and regulations on this *very* critical subject.

An extension *ad infinitum* of the principles set down in these loophole plugging cases merely tends to place an increasing burden on the Appellate Courts and becloud and render uncertain one of the most important areas of our tax law. Why should it be so difficult to define what a capital asset is *really* intended to be? Must not the Respondent himself shoulder a great deal of the blame for these constantly reoccurring cases and the maintaining of a challenge and temptation for the inventive genius of sophisticated taxpayers and their advisors? The Respondent, when he promulgated his own Regulations (§1.1221-1 Regs. under IRC 1954) for the sole purpose of stating *his* position and *his* interpretation of the meaning of Section 1221 of the Internal Revenue Code of 1954, saw fit to state only that "The term 'capital assets' includes all classes of property not specifically excluded by Section 1221. * * *". That's not much help is it?

How can the Respondent now complain of a result, absolutely compelled and required under the stipulated facts and the only statutory law on the subject, and founded on absolute good faith and freedom from any tax avoidance motives, in view of his own terse and indifferent declaration.

"Rules of Thumb" Invoked by Respondent Which Are Misleading, Inapplicable or False.

(A) The Respondent argues that since Petitioner reported some periodic payments under the water contracts, before they were sold, as ordinary income, the valuable property rights owned by Petitioner must partake of the nature of ordinary income. Why? Where is that spelled out in the law? A copyright or a royalty is a "valuable property right" which produces ordinary income, and yet it is generally accepted as a capital asset, and a capital gain results when it is sold. What is fatally inconsistent or offensive about Petitioner's position on this point? By reporting a few sporadic payments as ordinary income, Petitioner did not make an irrevocable election or a conclusive admission with respect to the nature of the underlying asset. It must be remembered that the right to receive a percentage of the revenue from water sales was dependent on the performance of others, and there was *no* expected uniformity of payments or guarantee of a specific recovery.

(B) The Respondent points out that Petitioner was permitted (as a result of *Albert Gersten,* 28 T. C. 756 (1957) and Respondent's acquiescence thereto) to deduct, on the theory of immediate amortization of its entire capital outlay, all of the cost of the valuable property rights which it sold. Now says the Respondent, having recovered its capital or cost, Petitioner should not be permitted to sell these valuable property rights as a capital asset having a zero basis. Why not? What is offensive about this result under these circumstances? Is this result not similar to the ultimate sale of any other fully amortized or depreciated capital

asset? In such a case, the taxpayer has always recovered his capital; and when he sells such a capital asset, the transaction is uniformly treated as the sale of a capital asset with a zero basis, and a capital gain is the result.

(C) The Respondent, in his Brief, also makes the comment that these water contracts were not acquired for investment purposes. (Resp. Br. p. 21.) Where is it suggested in the law or regulations that a capital asset *must* be acquired for investment purposes? A person's home is certainly a capital asset, yet few of us acquire it for "investment purposes". This is another attempt by Respondent to drag in and superimpose rules of thumb and theories, taken out of context and having no materiality or conclusive effect when applied to the law and facts here involved.

It is respectfully submitted that if the Respondent is beset by vague and gnawing anxieties about the inescapable conclusion in this case, then he should be encouraged to elaborate on his own Regulations, and the courts should join in encouraging Congress to give us a workable law on this important subject. The courts have enough to do without trying and retrying "capital gain cases" and thereby adding to inherent ambiguity and stimulating a cat-and-mouse game with resourceful taxpayers and their advisors.

The Petitioner, in the best of good faith, complied with all of the existing statutory law and the Commissioner's own Regulations in a straightforward arm's length transaction. This transaction must be accorded the result which those mandates require. The Tax Court's rationalization and the Respondent's groping theories must be rejected.

III.

Answer to Respondent's Alternative Suggestion That the Water Contracts Were Assets in Which Petitioner Dealt in the Normal Course of Its Business.

The alternative argument set forth by Respondent in his Brief, and also alluded to by the Tax Court in its Opinion [Resp. Br. p. 19—Tr. 34—T. C. Op.], that the water contracts were "acquired by Petitioner in the normal course of its everyday business activity" and should therefore be treated like the securities of an investment broker or the real properties of a real estate broker, is without merit. Naturally, capital gain treatment is not accorded to people who are regular dealers in a certain type of assets, even though those assets might be capital assets in the hands of others. When the stockbroker deals in securities, he is in the same position as the grocer selling canned goods off the shelves. This rule is too well settled to require the citation of authorities. Respondent in his Brief cites the case of *Corn Products Co. v. Commissioner,* 350 U. S. 46. The distinction between our case and the well established rule stated above, and also the *Corn Products* case, is that this Petitioner did *not* repeatedly or continually deal in these water contracts. They were not "an integral part" of Petitioner's business or directly related to Petitioner's business. Petitioner had never sold any such contracts before the sale in question. [Tr. Supp. 64.] The valuable property rights represented in these water contracts were a most casual by-product of Petitioner's business, which is the business of improving residential real property for sale. Acquisition of the water contracts was a necessary and onerous invest-

ment which Petitioner was required to make. To suggest that Petitioner dealt in such contracts is an absurdity. The water contracts were a residual property of residual value, but without further usefulness or purpose when Petitioner had completed its homes and they were ready for sale to occupants. The water contracts at that time might be likened to any other residual property, such as specialized rolling equipment which, let us say, had been used in Petitioner's trade or business and was fully amortized or depreciated. When Petitioner undertook to dispose of by sale these residual properties, whether they be the water contracts or the specialized rolling equipment, the sale of such items is the sale of capital assets with a zero basis. Petitioner in its Opening Brief makes reference to §1231 of the Internal Revenue Code of 1954 and comments on this analogy. (Pet. Op. Br. pp. 13-15.)

In conclusion Petitioner again respectfully submits that the *only* reasonable inference that can be drawn, from the undisputed facts of record and the existing law on the subject, is that it is entitled to long-term capital gain treatment on the sale of a capital asset as reported by Petitioner on its return for its fiscal year ended April 30, 1958, and that the Tax Court's Opinion to the contrary is erroneous and must be reversed.

Dated: July ...., 1964.

Respectfully submitted,

F. Edward Little,
J. Keith McGregor,
Counsel for Petitioner and Appellant.

Certificate.

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

F. Edward Little